UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

San Diego Gas & Electric Company

v. Docket No. EL00-95-000

Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and the California Power Exchange

Investigation of Practices of the California Independent System Operator and the California Power Exchange, et al. Docket Nos. EL00-98-000, et al.

(Issued November 1, 2000)

HÉBERT, Commissioner, *concurring:*

Introduction

As much as I would like to offer a recitation that would be more to the liking of San Diegans, and sit as the most popular member of this Commission, my oath, taken almost exactly three years ago on this date, requires me to regulate in a forthright and intellectually honest fashion. We must provide supply and deliverability opportunities in America and, especially, in California. Worse than high prices, reliability concerns for the good people of California must be a priority.

Recent events demonstrate two things. California wholesale electricity markets require reform. And California ratepayers deserve relief.

In today's order, the Commission attempts to accomplish both tasks. Frankly, in my judgment, it is not altogether clear whether the Commission has moved in the direction of achieving its stated goals of reforming California markets and helping California ratepayers. If it were up to me, today's order would be much, much different.

Nevertheless, on balance, today's order appears to be a step in the right direction. For this reason, I hesitantly concur. However, there remains much uncertainty as to the

practical effect of various remedial measures adopted in today's order. I can support the order only because it does not represent the last word; it is merely a "proposed" order. A technical conference and a round of comments from the public will follow. If, after listening to comment on the subject, I am convinced that the Commission has moved in the wrong direction – and I am perilously close to that conviction right now – I will not be hesitant to upset the basket of remedial measures adopted today.

I write separately to present for comment the basket of remedial measures I would adopt, if given the chance. I agree with today's order to the extent it explains that California electricity markets suffer from serious structural defects that inhibit the operation of a competitive market. I also agree that the current situation requires "decisive" action; otherwise, California markets will not move toward the goal we all agree on. The Commission needs to act now to ensure that energy suppliers have an incentive to enter capacity-starved California markets, that local utilities have strong reason to hedge against price risk, that entrepreneurs have a motivation to develop new products and technologies, and that consumers share a motivation to conserve.

I simply disagree with today's order with respect to its selection of corrective measures. Some will help; others will hurt. Others not selected would have helped more. The Commission should have stopped with corrective measures designed to remove impediments from the operation of a competitive market. Instead, unfortunately, it decided to go farther and adopted additional measures that prescribe with tremendous specificity how market institutions and market participants should act during the transition period to a fully competitive market. The majority of the Commission believes that various prescriptive measures will ease the pain felt by market participants during what it believes will be a two-year transitional period.

I believe, however, that the Commission's overreaching will only prolong the transition period for an indefinite period. If the Commission were truly committed to the competitive ideals articulated in today's order, it would have taken "decisive" action to ensure that California markets achieve those ideals as quickly as possible. Now is not the time for timidity. California ratepayers will benefit from the restructuring of the California energy market only when that market is allowed to operate without artificial restraints designed by regulators who believe that they know best how to serve energy customers.

I now proceed to explain the basket of remedial measures I would adopt to address the California electricity situation. I then explain those measures adopted by the Commission that I would not have adopted. I finish with a discussion of the Commission's attitude toward refunds.

Remedial Measures I Would Adopt

1. Eliminate All Price Controls

Today's order is filled with repeated references to the perceived need for "price mitigation." As a general matter, I find the concept of "price mitigation" to be an offensive one. Government should not be mitigating prices. It is ill-equipped to do so; its efforts invariably back-fire to the detriment of consumers. Rather, market participants – primarily energy suppliers and energy consumers – should be entrusted with the ability and the responsibility to mitigate their price exposure as they deem best.

This is a subject that I have written about in numerous dissents and concurrences over the past three years. Events in California demonstrate that my position is not merely academic or philosophical. In a report dated September 6, 2000, the Market Surveillance Committee of the California ISO concluded that price caps have little ability to constrain prices. Specifically, it noted that monthly average energy prices in California during June of this year, when the price cap was $750/MWh, were lower than monthly average energy prices during August of this year, when the price cap was $250/MWh – even though energy consumption was virtually the same in both months.

Moreover, the Commission's own Staff Report suggests that there is a direct correlation between lower price caps and higher consumer prices. Specifically, it finds that decreases in the ISO price cap this past summer were matched by increases in exports of electricity out of California during the same period. The resulting decrease in net imports, historically relied upon by California, is one of the principle reasons for the increase in wholesale electricity prices.

For these reasons, I am gratified that the Commission today decides to reject the price cap proposed by the PX and the purchase cap amendment filed by the ISO. I agree with the rest of the Commission that the price cap has served to keep sellers out of California markets and has inhibited the incentive of electricity purchasers to engage in forward contracting and thus hedge against price volatility and uncertainty.

Unfortunately, the Commission does not stop here. Instead, it proceeds to take additional "mitigation" action that belies its stated intention to allow competitive markets to send price signals to suppliers and customers.

2. Abolish the Single Price Auction

The Commission abandons a hard cap and imposes a soft cap in its place. This is accomplished through the Commission's modification of the single price auction. In

today's order, the Commission creates two distinct categories of bids into the PX and ISO. Sellers bidding below $150/MWh will be subject to little scrutiny. Sellers bidding in excess of the $150 threshold, however, will be subject to tremendous scrutiny. Today's order explains in considerable detail all of the information the PX, ISO, and each seller must report for each bid in excess of $150. Moreover, the order states ominously that the purpose of the enhanced reporting requirements is not simply to monitor market behavior. Rather, it explains that the Commission will use this information "to adjust transaction prices, if necessary, to establish just and reasonable rates."

Thus, to me, the practical effect of today's modification to the single price auction is to clearly disfavor all bids in excess of $150. While the order states that the Commission is not preventing a supplier from bidding in excess of that number and receiving its bid, I doubt that suppliers will be anxious to take advantage of that opportunity and to incur the Commission's wrath. I ask for comment as to whether my doubts are shared by the industry.

I would simplify matters considerably. I would not select an arbitrary $150 figure and leave it in place for an equally arbitrary 24-month period. Instead, I would do what numerous participants in our California proceeding have been asking us to do – eliminate the single price auction altogether.

Despite its length, today's order is surprisingly silent as to the merit of abandoning the single price auction. (This is one of the remedial options identified in the Staff Report.) I fail to perceive any compelling reason why any bid should set the price for the entire market. If the market clearing price for the final increment of needed capacity is, say, $100 MWh, why should a supplier who bid a lower figure receive the same value as that afforded to the supplier of higher-priced increment? Similarly, if the market clears in excess of $100, why should that clearing price set the market price?

My preference is that sellers in California be paid what they bid, regardless of what that bid is, rather than the market clearing price. I can think of no other action that would be more effective in lowering rates to truly competitive levels.

3. Terminate the Mandatory Buy-Sell Requirement in the PX

This is one topic that the Commission gets right in most respects. Wholesale customers should have the ability to name their own price. The Priceline.Com model is, in its most basic form, applicable to wholesale electricity. Purchasers do not need the government to intercede to limit upside price risk. Rather, purchasers have the ability to do this for themselves, if government does not interfere to limit their ability to take advantage of financial instruments and contracting options.

Today's order concludes that the existing requirement that investor-owned utilities sell all of their generation into and buy all of their requirements from the PX contributes significantly to rates that are unjust and unreasonable. I agree. The Commission correctly removes this encumbrance to trading options. Load-serving utilities should have full opportunity to pursue a portfolio of long- and short-term resources and to reach whatever markets are best suited to meet the needs of their customers.

Unfortunately, in its zeal to promote hedging opportunities – a laudable goal to be sure – the Commission goes too far. I explain later in this statement my objection to the Commission's decision to dictate to market participants how best to manage risk.

4. Direct the ISO and PX to Address Remaining Impediments in Their January, 2001 RTO Filing

Today's order expends many pages addressing numerous other flaws in the California market design. Specifically, the order discusses reserve requirements, congestion management redesign, reliability and operational measures, governance structures, demand response, balance scheduling, generation interconnection, and market monitoring and mitigation. The Commission requires specific responses to certain of its concerns. It directs market institutions and participants to consider and report back on other concerns.

I am greatly concerned that the Commission, in its desire to appear active and engaged, is greatly undermining the ability of the ISO and PX to make its regional transmission organization (RTO) filing. That filing is due to be filed no later than January 16, 2001 – only 2 ½ months from now. I have no problem with the Commission identifying its concerns in this order. However, I would ask the ISO and PX to take these concerns into accounts when they make their RTO filing. By asking the ISO and PX to act immediately on some measures, relatively soon (short-term) on other measures, and somewhat more leisurely (long-term) on still other measures, the Commission is greatly inhibiting the ability of the PX and ISO to respond effectively to their RTO filing obligation. The Commission is also hindering, and in some cases pre-judging, its ability to act on that filing once received.

Remedial Measures I Would Not Adopt

1. Modify the Single Price Auction

I have already explained my preference for abandoning, rather than modifying, the auction rules used by the PX and ISO. If the Commission insists on modifying, rather than terminating, the single price auction, I would offer a different modification.

Specifically, I would start the single price auction for all sale offers at or below $250 MWh. I would not lower the de facto price cap below the figure currently in place and previously approved (over my dissent) by the Commission. The Staff Report indicates (at 6-12) that the existing ISO cap already appears to be too low, and that it comes close to the variable costs (fuel and emissions) of a combustion turbine. The Report continues that a price cap at the existing level is unlikely to be high enough to attract new investment.

If the Commission is insistent that it must have a single price auction dollar figure in place, I would not leave it at that figure for the entire period of the transitional period. Rather, I would escalate that figure upward by specific amounts (say, $250 or $500 amounts) at specific intervals (say, every six months). In this manner, California market participants and institutions, in conjunction with California regulators and legislators, will have the incentive to respond immediately to the market design flaws identified in today's order. For example, the Commission has no authority to direct the state of California to expedite its siting and permitting procedures, or to drop remaining impediments to forward contracting. A price cap escalator, however, would act to spur all market players to adopt new and badly-needed remedial measures

2. Disband Stakeholder Boards at This Time

I have no particular fondness for the stakeholder Governing Boards for the PX and the ISO. As today's order correctly explains, the decision-making process is overly complex, mired in controversy, and prone to excessive influence by special interest groups. In operation, the Boards function as little more than a debating society among various market participants. Their governance structure is no model for how a transmission grid or centralized exchange should be operated. The structure is certainly no model for how a competitive business should be run.

Despite all of my misgivings, I would not proceed, as the Commission does today, to dictate right now how the Governing Boards should be restructured. Governance and independence are topics, I presume, that the ISO and PX are vigorously debating as they prepare their RTO filing. They very well may decide to adopt the independent, non-stakeholder governance structure preferred by the Commission in today's order. But, then again, they may not. This is ultimately a matter to be addressed by the ISO and PX, after consultation with various market participants, in the first instance and for the Commission to consider only after receiving the California RTO filing.

By insisting upon a non-stakeholder structure right now, the Commission is betraying its principles as articulated in Order No. 2000. The Commission stated its preference for flexibility and initiative. It also indicated that what works well in one

region of the country may not work as well in other regions. I have no idea whether the Boards of ISOs in New York, New England, and PJM would have responded any more effectively and independently than the California ISO and PX Boards, had they been presented with similar market problems. Today's order assumes that governance structures in the East would have operated more effectively than the existing governance structure in the West. I would make no such assumption.

Indeed, all of the Commission's articulated concern for independence and effective decision-making merely confirms my belief that by far the most independent and effective governance structure is that found in an independent transmission company. Despite my enthusiasm for a transco, I would not dare suggest that the Commission impose one on California right now in punishment for the conduct of the California Governing Boards this past summer.

Finally, the Commission is needlessly provoking a constitutional show-down. The Governing Boards are the product of legislative decisionmaking. As a practical matter, I doubt they can be replaced in the time frame contemplated in today's order. Moreover, left unexplained is what the Commission intends to do if the ISO and PX balk at the requirement to adopt immediately a non-stakeholder governance structure. This is precisely the reason why the governance structure should be negotiated and worked out in the context of the collegial RTO process – not determined immediately by regulatory fiat.

3. Dictate to Market Participants How Best to Manage Risk

I share the Commission's enthusiasm for risk management and forward contracting. A prudent utility, I assume, would spread out its risk and procure a diversified portfolio of contracts. This Commission and the California Commission, to the extent possible, should encourage the scheduling of load in forward markets (daily, weekly, monthly, annually, etc.) and should discourage scheduling in real-time (spot) markets. California utilities that failed to take advantage of forward contracting options, because of inattentiveness or regulatory inhibitions, were badly burned this past summer when real-time electricity prices sky-rocketed.

Nevertheless, I draw the line at dictating to market participants precisely how much of their transactions to schedule in forward markets and how much to schedule in real-time markets. I have no basis for assessing what an optimal allocation between forward and real-time scheduling should look like. I believe that no single risk allocation portfolio is appropriate for all market participants. And I believe that no market participant should be locked into a particular allocation method once established. This is, ultimately, a decision to be made by market participants based upon their own risk tolerance and their own evaluation of competitive and financial opportunities.

(Hopefully, market participants will be able to make such a decision now that the Commission is eliminating the mandatory buy-sell requirement in the PX.)

I understand that there is a fine line between managing risk and operating in a reliable manner. The Commission justifiably raises a concern in today's order that underscheduling of load and generation in day-ahead and day-of markets forces the ISO to operate an energy market and places system reliability at risk. However, the answer to this concern is not to compel market participants to schedule 95 percent or more of their transactions in forward markets. Rather, I would prefer to direct the ISO and PX to address the underscheduling issue in their forthcoming RTO filing.

Refunds

I choose to close with a discussion of refunds, so as to stress the importance of this issue.

The Commission needs to be honest and forthright with California ratepayers on the subject of refunds. It is a basic premise of responsible government that the American public should know precisely where their elected and appointed officials stand. This is particularly true in California, as the Commission has promised in its orders and in its hearings that it would decide quickly and decisively whether to order refunds.

I believe that the Commission has failed as to this basic responsibility. It is now November 1, and California ratepayers are no closer to a final decision on their claim to refunds for perceived overcharges during the summer. Today's order employs mushy and confusing language on the subject of refunds, indecipherable to all but the most devoted of FERC insiders. I would be more direct.

As for refunds for past periods, today's order concludes that legal authority offers "strong support" for the proposition that the Commission lacks authority to order retroactive refunds. I would not be so equivocal. The Federal Power Act rests on a legislative preference for rate certainty. Refunds and rate revisions, absent a utility filing, are reserved for periods subsequent to the filing of a customer complaint or the initiation of a Commission proceeding. I discern no exception for market-based (as opposed to stated) rates.

I fail to see how the Commission, even if it wanted to order refunds for prices charged to San Diegans during the summer of 2000, could do so in the present circumstances. Neither the Staff Report nor today's order contains any finding that any power supplier exercised market power or otherwise engaged in inappropriate behavior. Indeed, neither the Staff Report nor the order reaches definite conclusions about any

seller or category of sellers. In these circumstances, how could the Commission order individual sellers or categories of sellers to make refunds, much less allocate responsibility for refunds among sellers?

Curiously, the Commission does state in a footnote that is willing to consider "other forms of equitable relief" to mitigate the "severe financial consequences of last summer's high prices." Frankly, I do not know what this statement means. If the Commission intends to suggest that it enjoys the power to do indirectly what it cannot do directly – i.e., exercise its considerable powers of persuasion to motivate power suppliers to reimburse buyers in some respect -- then I reject that suggestion as legally unfounded.

As for refunds for future periods, today's order informs power suppliers that their sales into California ISO and PX markets are now "subject to refund." I addressed the practical effect of "subject to" language in my concurrence to the August 23 order initiating the Commission's investigation into California markets. 92 FERC at 61,611. I believe that the inclusion of "subject to" language will act to exacerbate supply deficiencies in California. This is because power suppliers, uncertain whether the Commission later may decide to alter the rate they have charged, justifiably will decide to sell their capacity in markets outside California. This will only accelerate the exodus of power outside California, a factor recognized by the Staff Report as contributing to the summer increase in the wholesale price of electricity.

I also have serious reservations about conditioning market-based rate authorization on maintaining a "subject to refund" obligation through the end of 2002. This has the practical effect of extending the refund protection under section 206 of the FPA for a total of 27 months of protection. In contrast, section 206 is explicit that, absent dilatory behavior of the type not present here, refund relief may extend only 15 months from the refund effective date established by the Commission (here, October 2, 2000).

To address credible claims of anticompetitive behavior, I would employ the Federal Power Act as it was drafted and promulgated, not as it arguably should be revised to recognize modern-day power sales. I continue to believe that the Commission should act vigorously to detect and remedy real abuses of market power. If a complaint or Commission staff-initiated investigation can establish, to the Commission's satisfaction, such an abuse, the Commission should order refunds prospective from the date of that complaint or investigation. By directing the imposition of a "subject to refund" condition on California sellers of power, the Commission now goes beyond the limitations of the FPA by allowing for the potential award of refunds for conduct prior to the filing of a complaint or the initiation of an investigation.

Next Tuesday represents the most political day of our American heritage. It is our birthright as Americans. Today, there is no room for politics. The question is not whether or not I want to give refund relief to California ratepayers. I do, but I want to follow the law. I am certainly not above it.

Conclusion

In conclusion, there is much I like and much I dislike about today's order. I believe that it is important to keep the process moving forward and to inform California ratepayers and officials of our judgments as soon as possible. I look forward to public input. I remain committed to respond to the needs of California ratepayers in a balanced manner that, hopefully, will allow them to enjoy the benefits of a competitive market as quickly as possible.

For all of these reasons, I respectfully concur.

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Curt L. Hébert, Jr.
Commissioner